

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snively King Majoros O'Connor & Lee, Inc.

processing costs.³⁹ Andersen notes that ILEC competitors do not have to disclose their mix of technology.⁴⁰

Andersen's reference to ILEC competitors is irrelevant. ILEC competitors do not possess market power and are thus not regulated. Since the ILECs retain market power, they must remain regulated, and their operations must be open to public scrutiny.

Andersen's contention that "a switch is a switch" is an oversimplification. For example, the cost of maintaining electro-mechanical switches is twice that of analog or digital switches.⁴¹ Economic depreciation rates are very different for different switch technologies. The capabilities of digital switches far exceed those of analog or electro-mechanical switches. All of these considerations must be incorporated in cost of service studies to develop just and reasonable rates. The compositing of data would greatly diminish the quality of such studies. Indeed, investment decisions are a function of operating and maintenance costs as well as initial investment costs, and detailed information is needed to identify what forward-looking technologies and forward-looking costs actually are.

Similarly, Andersen would eliminate the separate accounting for copper and fiber cables.⁴² To Andersen, it can be assumed, "a cable is a cable." As with switches, however, the costs and capabilities of copper and fiber vary greatly and require separate cost of service treatment. The Commission's responsibility to ensure just and reasonable rates requires close scrutiny of ILEC cost

³⁹ Id., p. 23.

⁴⁰ Id.

⁴¹ See Attachment 2, Column c.

⁴² Andersen Paper, p. 33.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavely King Majoros O'Connor & Lee, Inc.

of service studies, and such scrutiny demands the ability to distinguish between the characteristics of differing switch and cable technologies.

Furthermore, the Commission has a responsibility to encourage the development of advanced technologies.⁴³ To meet this responsibility, it is imperative that the Commission track the technology mix of the large ILECs.

4. Notification Requirements Remain Necessary

Andersen recommends the elimination of the requirement that ILECs notify the Commission prior to adopting new accounting standards and file related revenue requirement studies.⁴⁴ Andersen also recommends that prior approval be eliminated for the booking of extraordinary items, prior period adjustments and contingent liabilities.⁴⁵ Instead, Andersen would have the Commission rely on GAAP and review by the Securities and Exchange Commission ("SEC").⁴⁶

As discussed above, GAAP protects the interests of investors, not ratepayers. The SEC's responsibilities are similarly focused, as are those of independent auditors, such as Arthur Andersen. It is only the duly appointed Federal and State regulators who have a statutory responsibility to balance the interests of investors with those of ratepayers to ensure just and reasonable rates. As the Commission found in its GAAP order, prior Commission review is not unduly burdensome.⁴⁷ In fact, prior review has worked to the benefit of both ILECs and ratepayers over the years. In most

⁴³ Telecommunications Act of 1996, Section 706.

⁴⁴ Andersen Paper, p. 23.

⁴⁵ Id., p. 24.

⁴⁶ Id.

⁴⁷ GAAP Order, para. 73.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavely King Majoros O'Connor & Lee, Inc.

cases, prior review has resulted in prompt approval of ILEC proposals. In cases where significant revenue requirement changes were involved, prior review has ultimately resulted in appropriate bookings without the confusion and cost of revisions to ILEC accounts.⁴⁸ Prior notification is the ounce of prevention which has spared the ILECs a pound of cure.

⁴⁸ See, e.g., Southwestern Bell and GTE Service Corporation Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting For Postretirement Benefits Other Than Pensions, Order, 6 FCC Rcd 7560 (1991).

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

**V. THE COMMISSION'S PROPERTY RECORD AND
DEPRECIATION RULES REMAIN NECESSARY**

A. Analysis of Andersen's Position

Andersen's position with respect to plant accounting and recordkeeping is summarized as follows:

The Part 32 requirements with respect to telecommunications plant accounting and recordkeeping are significantly more detailed than what GAAP requires and should be eliminated or at a minimum significantly reduced. The level of detail at which accounts, subaccounts and detailed plant record categories are defined far exceed the recordkeeping necessary to verify the existence of plant assets and support the assets balances presented in the financial statement.⁴⁹

Andersen's narrow definition of the recordkeeping necessary with respect to plant assets may be appropriate for a nonregulated firm, but it is certainly not applicable to the ILECs.

Local telephone operations are very capital intensive. As discussed above, the prices of local telephone services remain dependent on the cost of providing them. In turn, the costs of providing most local telephone services are largely dependent upon the plant required to provide them. These plant related costs include depreciation, maintenance and a return on capital investment.

Because of the importance of plant investment in the determination of just and reasonable ILEC rates, Part 32 places stringent plant accounting and recordkeeping controls on the ILECs. Because of the importance of depreciation to the costs of local exchange services, the Commission

⁴⁹ Andersen Paper, p. 25.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snively King Majoros O'Connor & Lee, Inc.

was given the responsibility for prescribing ILEC depreciation rates.⁵⁰

Andersen is highly critical of the depreciation rates prescribed by the Commission. Andersen states:

Depreciation lives have historically been set for regulatory accounting purposes in excess of the true economic lives of assets based upon the use of historic retirement data. As noted above, when the large LECs discontinued the application of SFAS No. 71, billions of dollars in write-downs of telecommunications plant asset balances to their estimated net realizable value were recorded for external reporting purposes.⁵¹

Andersen's criticisms are way out of date.

In 1980, the Commission recognized that "[t]he seeming attraction of stretching out lives to hold down depreciation expense may impose longer-term costs on our society that far outweigh short-term advantages."⁵² The Commission determined that many of the life estimates being used to establish depreciation rates were unrealistically long, and directed its staff to develop new procedures to reduce the possibility that such large errors in forecasts would occur again.⁵³ The Commission staff responded by placing less emphasis on historic data and paying closer attention

⁵⁰ For all ILECs providing full financial reports to the Commission in 1997, depreciation expense (\$21.2 billion) represented over 20 percent of reported revenues (\$103.1 billion). Preliminary Statistics of Communication Common Carriers, Table 2.9.

⁵¹ Andersen Paper, p. 30.

⁵² Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies), Docket No. 20188, Report and Order, FCC 80-650, released December 5, 1980, para. 49.

⁵³ Report on Telephone Industry Depreciation, Tax and Capital/Expense Policy, Accounting and Audits Division, Federal Communications Commission, April 15, 1987 ("AAD Report"), p. 8.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

to company plans, technological developments, and other future-oriented analyses.⁵⁴

The effect of this change to a forward-looking orientation has been dramatic and can be seen by tracing depreciation reserve levels. As the Commission has recognized, "[t]he depreciation reserve is an extremely important indicator of the depreciation process because it is the accumulation of all past depreciation accruals net of plant retirements. As such, it represents the amount of a carrier's original investment that has already been returned to the carrier by its customers."⁵⁵

The Commission's recognition of the reserve level as an indicator of the depreciation process can best be understood by examining a steady state example. Assume that we start with a stable environment in which the average age of plant is 9 years and the expected life of plant is 27 years. In this case, the add rate, retirement rate and straight-line accrual rate are all 3.7 percent, and the reserve level is stable at 33 percent of plant in service (9 years/27 years).⁵⁶ As we vary these factors, we can see the effect on the reserve level. For example:

- If the add rate were to increase above 3.7 percent, the reserve level would go down. This would not be a cause for concern, since the average age of plant would similarly represent a lower percent of its expected life.
- If the retirement rate were to increase above 3.7 percent, the reserve level would go down. This would be a cause for concern, since it would indicate that the expected life of plant is shorter than previously expected. If the expected life is shorter, the average

⁵⁴ Id.

⁵⁵ Id. pp. 5-6.

⁵⁶ The reserve will stabilize at 33 percent assuming a triangular (straight-line) mortality curve. See Notes for Engineering Economics Courses, American Telephone and Telegraph Company, Engineering Department, 1966, p. 121.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

age of plant would represent a higher percent of its expected life, and the reserve should be higher, not lower than 33 percent.

- If the accrual rate were to increase above 3.7 percent, the reserve level would go up. This would not be appropriate absent a reduction in the expected life of the plant, since it would indicate that the age of plant is higher than 33 percent of its expected life.

In summary, a declining reserve percent would be a reason for concern absent indications that it is merely the result of growth in plant. On the other hand, a rising reserve percent is generally a positive sign that the depreciation process is working well. Indeed, absent indications that the expected life of plant is decreasing, a rising reserve might be a sign that accrual rates are too high.

Attachment 3 to this report displays reserve levels and other plant rates since 1946 for all ILECs providing full financial reports to the Commission. As shown on Page 1 of Attachment 3, the reserve percent decreased steadily following World War II due to industry growth. These declines continued through the 1970's due in part to accrual rates which were too low.⁵⁷ As shown on Page 1 of Attachment 3, however, the Commission's change to forward-looking depreciation practices in the early 1980s resulted in a dramatic rise in reserve levels after 1980. The composite reserve level rose from 18.7 percent in 1980 to an historic high of 48.8 percent in 1997. This track record indicates that the depreciation process is resulting in adequate depreciation accruals, and that the Commission's life estimates have been forward-looking and unbiased.

Confirmation of the forward-looking nature of current Commission prescriptions can be gained by comparing the 1997 accrual rate of 7.1 percent (Attachment 3, Page 4, Column l) to the 1997 retirement rate of 4.0 percent (Attachment 3, Page 4, Column k). The prescription of an

⁵⁷ AAD Report, p. 7.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavey King Majoros O'Connor & Lee, Inc.

accrual rate much higher than the current retirement rate indicates an expectation that the retirement rate will be much higher in the future. If the Commission were prescribing depreciation rates based upon historical indicators, it would be prescribing depreciation rates in the range of 3 to 5 percent.

This rise in reserve levels has largely eliminated reserve deficiencies for the large ILECs. As Attachment 4 shows, as of January 1, 1998, the large ILECs had a reserve surplus of over \$4.5 billion. In summary, Andersen's criticism of the depreciation rates currently prescribed by the Commission is unfounded.

Andersen's comparison of annual fixed asset and depreciation accounting costs indicates that the cost for the average LEC Coalition member is about \$7 million more than for the companies in its Non-Telco group.⁵⁸ Taken at face value, this represents a cost of regulation. This \$7 million is only five one-hundredths of one percent (.0005) of the 1997 operating telephone company revenues of the average LEC Coalition member (\$13.8 billion).⁵⁹ Given the critical importance of plant to the effective regulation of the ILECs, this is a small price to pay for just and reasonable rates.

B. Andersen's Recommendations Should Be Rejected

1. The Commission Should Continue To Prescribe Depreciation Rates

Andersen recommends that the Commission "decline any further involvement with respect to depreciation," and allow the ILECs to set whatever rates they please by whatever method they choose.⁶⁰ Andersen suggests, in fact, that GAAP depreciation would be appropriate.⁶¹

⁵⁸ Andersen Paper, p. 32.

⁵⁹ See Attachment 1 for list of LEC Coalition member 1997 revenues.

⁶⁰ Andersen Paper, pp. 35-36.

⁶¹ Id., p. 36.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

As discussed above, the Commission long ago determined that GAAP protects investors, not ratepayers. Given their incentive to keep reported regulated earnings low, and the conservative bias of GAAP, it is likely that the ILECs would find it appropriate to raise their depreciation rates to levels which would best protect investor interests. In essence, they would be prematurely freed from economic regulation.

Perhaps equally important, the end to Commission review of plant lives and salvage values would leave the State Commissions and the public without an unbiased perspective on these parameters for use in service cost studies. In interconnection arbitration cases across the country, for example, State commissions have found Commission prescribed (or similar State prescribed) depreciation parameters appropriate for use in Total Element Long-Run Incremental Cost ("TELRIC") studies.⁶² The lack of Commission depreciation parameter review could thus significantly affect the rates paid not only for interstate and intrastate services, but also for unbundled network elements. Both directly and indirectly, even universal service calculations ultimately depend upon the use of unbiased depreciation parameters.

In summary, Andersen's recommendation on depreciation would threaten not only the maintenance of just and reasonable rates, it would also adversely affect the Commission's competition and universal service initiatives.

⁶² See, e.g. Texas, Docket 16189, et al., November 8, 1996; Massachusetts, Docket DPU 96-73/74 et al., December 4, 1996; New York, Docket 95-C-0657, et al., April 1, 1997; West Virginia, Docket 96-1516-T-PC, April 21, 1997; Wyoming, Docket 70000-TF-96-319, 72000-TF-96-95, April 23, 1997; Delaware, Docket 96-324, April 29, 1997; Ohio, Docket 96-922-TP-UNC, June 19, 1997; Colorado, Docket 96S-331T, July 28, 1997; Maryland, Docket 8731, Phase II, September 22, 1997; Louisiana, Docket U-22022/22093, October 22, 1997; Georgia, Docket 7061-U, December 16, 1997; Illinois, Docket 96-0569, February 17, 1998; Virginia, Docket 970005, May 22, 1998.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

2. Property Units Should Not Be Redefined

Andersen recommends that the ILECs be given free reign to consolidate plant accounts and roll-up Continuing Property Records ("CPRs") into higher-level retirement units.⁶³ Andersen contends that these changes are necessary "to allow the LECs to embrace and foster competition, while being a viable competitor."⁶⁴

As discussed above, the plant accounts provide the very foundation for most cost of service studies. The consolidation of switching and cable accounts would deprive regulators and the public of data critical to the effective review of such studies. The determination of forward-looking economic depreciation rates depends in part on the perspective to be gained from the retirement trends of existing technologies. The relationship of expense to capital investment varies widely among the various categories of plant, as shown on Attachment 2, Page 2, and the consolidation of plant records would deprive regulators and the public of such information. In short, the Commission must continue to control the definition of property units in order to ensure that data necessary for it to perform its responsibilities remains available.

3. BPR and CPR Requirements Should Not Be Significantly Modified

Andersen recommends that the ILECs be freed from the requirement to notify the Commission of proposed modifications to its Basic Property Records ("BPRs") and CPRs.⁶⁵ Andersen also proposes significant reductions in the Commission's requirements for the tracking of

⁶³ Andersen Paper, pp. 33-34.

⁶⁴ Id., p. 33.

⁶⁵ Andersen Paper, pp. 34-35.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snively King Majoros O'Connor & Lee, Inc.

plant assets.⁶⁶ This would allow the ILECs to spend their time “more effectively on other value-added, customer focused activities.”⁶⁷

As discussed above, prior notification is not unduly burdensome, and is in the best interests of the ILECs in the long-run. The maintenance of appropriate plant records is critical to the process of regulation, and the Commission must continue to oversee the procedures established by the ILECs in this respect.

The tracking of plant assets is also fundamental to the process of regulation. The Commission has a public interest responsibility to ensure that the ILECs do not overstate assets subject to regulation. Missing plant assets are obviously neither “used” nor “useful” in the provision of telecommunications services. Moreover, the overstatement of plant assets creates numerous additional inaccuracies affecting the regulatory process. Depreciation expense, for example, is overstated when depreciation rates are applied to missing plant. Similarly, plant expense ratios critical to service cost studies are overstated when current expenses are related to overstated plant balances. As discussed above, inaccurate service cost studies affect not only interstate and intrastate rates, but also interconnection rates and universal service calculations.

In this connection, the Commission has recently conducted an audit of GTE to determine the quality of its recordkeeping. The audit of GTE found that an astounding 36 percent of GTE’s plant was not located where its property records indicated.⁶⁸ The media has reported similarly disturbing

⁶⁶ Id.

⁶⁷ Id., p. 34.

⁶⁸ Telecommunication Report, March 23, 1998, p. 28.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

information with respect to the Bell Operating Companies.⁶⁹ The Chairman of the House Commerce Committee, Rep. Thomas J. Bliley, Jr., noted the importance of ILEC property records in a recent letter to Commission Chairman William E. Kennard:

“These carriers’ books of accounts are being used to resolve a number of important issues at both the federal and state levels - including ongoing federal and state efforts to promote local competition. If these books of accounts have been inflated with investments that cannot be located or do not exist, then competitive carriers seeking interconnection to the local exchange are bearing an unnecessary cost, thereby harming competition in the local exchange market.”⁷⁰

The elimination of the requirement to track the age of existing assets and the service life of property retired would deprive regulators and the public of data which remains especially useful to the depreciation process. As discussed above, the Commission has long employed a forward-looking orientation in the determination of depreciation rates. But data on the actually experienced service lives of plant remains important to provide a perspective on the reasonableness of proposed lives. Indeed, for some accounts, the trends in realized lives provide a very good indicator of future life expectancies. The elimination of age-related plant data would severely weaken the Commission’s ability to balance the interests of investors and ratepayers in the prescription of depreciation rates.

4. Expense Limits Remain Necessary

Andersen recommends that the Commission eliminate its involvement in setting expense

⁶⁹ See, e.g., Wall Street Journal, August 13, 1998, p. E1.

⁷⁰ Telecommunication Reports, August 24, 1998, p. 33.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

(versus capitalization) limits.⁷¹ Andersen contends that the Commission's limits "contradict GAAP accounting, which says that materiality should always be considered in the decision to capitalize costs or expense them."⁷² Andersen states that "GAAP provides an adequate safeguard to prevent excessive expense limits that would cause distortions in reported financial results."⁷³

As discussed above, the GAAP conservatism principle provides an adequate safeguard to investors, but not to ratepayers. In the GAAP Order, the Commission stated:

As we stated in the NPRM, the GAAP definition of materiality leaves too much to the discretion of parties not bound by our public interest responsibilities to be viable in a regulatory accounting scheme. The comments received have not persuaded us to change our position that we need to retain sufficient control over the revised USOA to insure that it functions as a useful regulatory tool. Instead, we agree with GTE that Commission oversight in this area will facilitate the goal of consistent application of GAAP in the revised USOA.⁷⁴

The establishment of inordinately high expense limits, for example, would increase the expenses reported by an ILEC in a given period. Since this would tend to understate reported income, rather than overstate it, it would be considered a "conservative" practice under GAAP. But in a regulatory environment, it would also serve to drive down reported rate of return. For ILECs

⁷¹ Andersen Paper, pp. 36-37.

⁷² Id., p. 19.

⁷³ Id., p. 37.

⁷⁴ GAAP Order, para. 76. Interestingly, in its Comments in the GAAP proceeding, Arthur Andersen stated that the Commission should not try to define materiality, but, instead should establish a materiality threshold such as a percent of total revenues or a dollar limit. GAAP Order, para. 36.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

under State rate of return regulation this would justify higher prices to current ratepayers. For ILECs under price cap regulation, it could result in low-end adjustments and mask inadequate productivity offsets. Overall, it would tend to increase prices to current ratepayers, with no guarantee that future ratepayers would see offsetting lower prices.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavely King Majoros O'Connor & Lee, Inc.

**VI. THE COMMISSION'S AFFILIATE TRANSACTION
RULES REMAIN NECESSARY**

A. Analysis of Andersen's Position

Andersen's position with respect to the Commission's affiliate transaction rules is summarized as follows:

The affiliate transaction rules contain in Section 32.27 of the USOA are unduly complex and require carriers to incur significant costs in order to comply with such rules. While relevant in the traditional rate of return regulation environment, the Section 32.27 rules (and related cross-subsidy concerns) are clearly less relevant under price cap regulation.

In the long-term, GAAP should be relied on in this area with minimum regulatory intervention.

Once again Andersen underestimates the need of the Commission and State regulators for rules designed to prevent the cross-subsidization of competitive services by ratepayers. As established above, price cap plans have not eliminated the need for the accurate segregation of regulated and non-regulated costs prior to jurisdictional separations. The Commission's affiliate transaction rules are an integral part of this process.

Andersen's reliance on GAAP is particularly inappropriate in this area. As Andersen admits, "[t]here is minimal guidance on accounting for related party transactions under GAAP."⁷⁵ Given GAAP's conservative bias, as described above, the Commission's rules represent the only protection ratepayers have over potential cross-subsidization by the ILEC's.

⁷⁵ Andersen Paper, p. 44.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavely King Majoros O'Connor & Lee, Inc.

Indeed, as Andersen's analysis shows, this protection costs the ILECs relatively little. Andersen's comparison of annual affiliate transaction costs indicates that the cost of the average LEC Coalition member is only \$1.3 million more than for companies in its Non-Telco group.⁷⁶ This \$1.3 million is less than one-hundredth of one percent (.0001) of the 1997 operating telephone company revenues of the average LEC Coalition member (\$13.8 billion).⁷⁷

B. Andersen's Recommendations Should Be Rejected

1. Asymmetrical Affiliate Transaction Rules Are Appropriate

Andersen recommends that the Commission eliminate its asymmetric affiliate transaction rules.⁷⁸ These rules require that services provided or assets transferred by regulated carriers to non-regulated affiliates be recorded at the higher of fully distributed cost ("FDC") or fair market value ("FMV").⁷⁹ Conversely, services provided or assets transferred to regulated carriers are recorded at the lower of FDC or FMV.

The Commission's asymmetrical affiliate transaction rules represent an appropriate and practical recognition of ILEC control and incentives. The ILEC alone determines which assets will be placed on the books of each of its organizational entities, and which services will be provided to other entities. And as long as they retain market power, the ILECs have the incentive to maximize the costs recorded on their regulated books. As discussed above, price cap plans reduce, but don't

⁷⁶ Id., p. 44.

⁷⁷ See Attachment 1 for list of LEC Coalition member 1997 revenues.

⁷⁸ Andersen Paper, p. 45.

⁷⁹ These rules apply only when there is no applicable tariff, interconnection agreement or prevailing price available.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

eliminate, this incentive. The Commission's asymmetrical affiliate transaction rules eliminate the temptation otherwise open to the ILECs to act on this incentive. As the Commission stated in its Joint Cost Order, "[t]he affiliate transaction requirements are a key part of our deregulatory effort and should be a small price for the carriers subject to our jurisdiction to pay in this regard."⁸⁰

2. Prevailing Price Rules Remain Appropriate

Andersen recommends the elimination of the requirement to apply the 50% threshold on a product-by-product and service-by-service basis for determining the existence of a "substantial" third party market and the validity of using prevailing market price for affiliate transactions.⁸¹ Andersen contends that the relevance of this requirement is reduced in the current price cap environment."⁸²

Once again, Andersen confuses "reduced" with "eliminated." While the relevance of the prevailing price requirement may be less under a price cap regime, it remains an important accounting safeguard. As discussed above, the control over transactions and the incentives of the ILECs remain such that rules such as the prevailing price standard remain necessary. While the 50% requirement may be somewhat arbitrary, it represents a reasonable balance between the interests of investors and those of ratepayers.

3. Annual FMV Studies Remain Appropriate

Andersen recommends that the Commission minimize the cost of FMV studies by

⁸⁰ Separation of costs of regulated telephone service from costs on non-regulated activities, CC Docket No. 86-111, Report and Order, FCC 86-564, released February 6, 1987 ("Joint Cost Order"), para. 292.

⁸¹ Andersen Paper, p. 45.

⁸² Id.

REPORT ON ANDERSEN POSITION PAPER

Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

implementing a materiality-based and/or rotational requirement for their performance.⁸³

As Andersen points out, the California commission provides such relief in its rules.⁸⁴ While annual FMV studies remain appropriate for significant transactions, the adoption of a \$100,000 materiality threshold, such as that in California, might be reasonable. Similarly, a rotational study plan may be reasonable for annual transactions under \$1 million.

4. Exemptions From FMV Determinations Should Be Limited

The Commission's rules now exempt a carrier from its FMV rules when the carrier purchases services from an affiliate which exists solely to provide services to the carrier's corporate family. Andersen recommends that this rule be modified to exempt carriers from the FMV rules when the service providing affiliate provides incidental or non-related services to third-parties.⁸⁵ Andersen also would exempt services provided by the regulated carrier to an affiliate that exists solely to provide services within the carrier's corporate family.

It would not be inappropriate for the Commission to establish a threshold percent (say 5%) under which an affiliate's third party, non-related services would be ignored. To use Andersen's illustration it is not likely that the incidental leasing of excess space in a building whose occupants provide procurement services would "taint" the cost of procurement services.⁸⁶ Exemptions should not be made, however, if such services are related to those purchased by the regulated carrier, since this could lead to cross-subsidization of competitive services by noncompetitive services.

⁸³ Id., p. 46.

⁸⁴ Id.

⁸⁵ Id., p. 47.

⁸⁶ Id.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

Services provided by the regulated carrier should not be exempted from the FMV requirement, however, even if these services are provided to an affiliate which exists solely to provide services within the carrier's corporate family. Such an exemption could result in an indirect cross-subsidy if the regulated carrier provided services below FMV to an entity who then cross-charged a non-regulated affiliate operating in competitive markets. Such "chaining" would result in the unlawful subsidization of competitive services by noncompetitive services.

REPORT ON ANDERSEN POSITION PAPER
Prepared By Snavelly King Majoros O'Connor & Lee, Inc.

VII. CONCLUSION

Andersen's proposed simplifications of the Commission's Part 32 accounting rules fail to recognize the purpose of these rules and the environment in which they operate. The primary objective of these rules is to provide the Commission and State commissions with the information they need to fulfill their regulatory responsibilities. Despite the introduction of price cap plans, stringent accounting safeguards remain necessary to prevent the ILECs from abusing their market power in the local exchange and exchange access markets.

Andersen's recommendation that the Commission place full reliance on GAAP ignores the fact that GAAP protects investors and not necessarily ratepayers. It is the Commission and State commissions that must balance the interests of investors and ratepayers to ensure just and reasonable rates.

As this report has demonstrated, the Commission's accounting, property record, depreciation and affiliate transaction rules remain necessary to protect ratepayers. With limited exceptions, as discussed in this report, Andersen's recommendations are not in the public interest and should be rejected by the Commission.

LEC Coalition 1997 Revenues

(Dollars in Millions)

Ameritech	11,775
BellSouth	14,666
GTE	13,368
SBC	18,952
US West	<u>10,022</u>
Total	68,783
Average	13,757

Source: 1997 Preliminary Statistics of
Common Carriers, Table 1.2

Telephone Plant in Service
All Reporting LECs - 1997
(Dollars in Thousands)

Account No.	Item	Class A a	Class B b
<u>General Support</u>			
2111	Land	1,302,693	
2121	Buildings	22,593,762	
	Total Land and Buildings	23,896,455	
2112	Motor Vehicles	2,802,306	
2113	Aircraft	40,847	
2114	Special Purpose Vehicles	2,231	
2115	Garage Work Equipment	107,805	
2116	Other Work Equipment	2,484,679	
2122	Furniture	484,976	
2123	Office Equipment	2,084,836	
2124	General Purpose Computers	<u>10,272,873</u>	
2110	Total Land & Support Assets	42,177,009	42,177,009
<u>Central Office Switching</u>			
2211	Analog Electronic Switching	6,923,001	
2212	Digital Electronic Switching	53,064,835	
2215	Electro-Mechanical Switching	<u>87,057</u>	
2210	Total Central Office Switching	60,074,893	60,074,893
2220	Operator Systems	954,529	954,529
<u>Central Office Transmission</u>			
2231	Radio Systems	1,364,019	
2232	Circuit Equipment	<u>57,760,638</u>	
2230	Total Central Office Transmission	59,124,657	59,124,657
<u>Information Orig/Term</u>			
2311	Station Apparatus	329,901	
2321	Customer Premises Wiring	143,466	
2341	Large Private Branch Exchanges	172,832	
2351	Public Telephone Terminal Equipment	1,339,544	
2362	Other Terminal Equipment	<u>2,956,396</u>	
2310	Total Information Orig/Term	4,942,141	4,942,141
<u>Cable & Wire Facilities</u>			
2411	Poles	6,055,758	
2421	Aerial Cable	31,701,992	
2422	Underground Cable	26,137,201	
2423	Buried Cable	50,995,111	
2424	Submarine Cable	99,624	
2425	Deep Sea Cable	17,793	
2426	Intrabuilding Network Cable	2,308,327	
2431	Aerial Wire	189,933	
2441	Conduit Systems	<u>17,031,443</u>	
2410	Total Cable & Wire Facilities	134,537,185	134,537,185
240	Total Plant	301,810,418	301,810,418

Plant Expense Ratios
All Reporting LECs - 1997
(Dollars in Thousands)

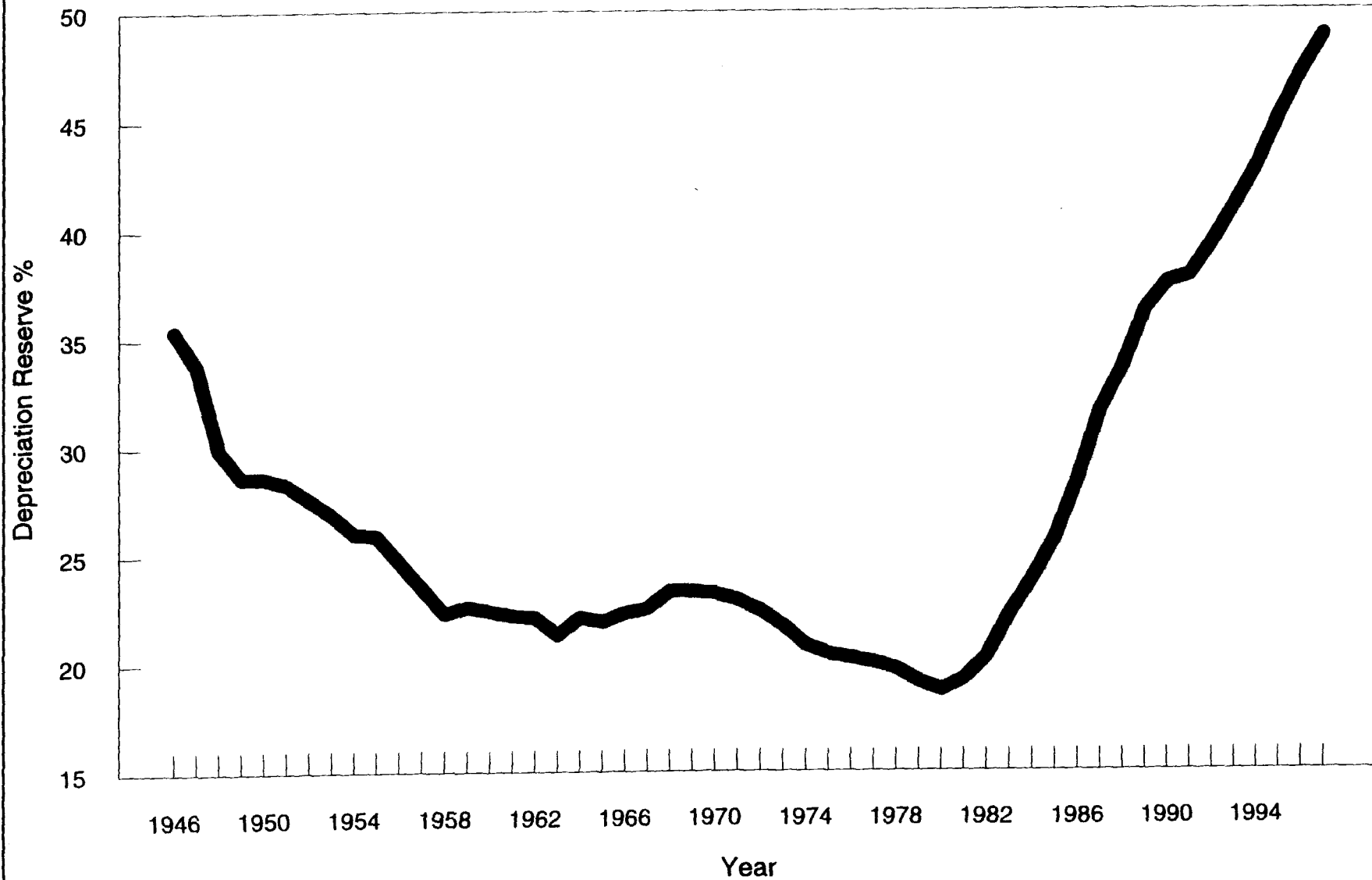
Account No.	Item	TPIS a	Class A		Class B	
			Expense b	Ratio c = b/a	Expense d	Ratio e = d/a
<u>General Support</u>						
2111	Land	1,302,693	--	--		
2121	Buildings	22,593,762	--	--		
	Total Land and Buildings	23,896,455	2,026,632	0.085		
2112	Motor Vehicles	2,802,306	573,636	0.205		
2113	Aircraft	40,847	21,078	0.516		
2114	Special Purpose Vehicles	2,231	557	0.250		
2115	Garage Work Equipment	107,805	6,318	0.059		
2116	Other Work Equipment	2,484,679	250,658	0.101		
2122	Furniture	484,976	164,159	0.338		
2123	Office Equipment	2,084,836	303,977	0.146		
2124	General Purpose Computers	<u>10,272,873</u>	<u>2,465,167</u>	<u>0.240</u>		
2110	Total Land & Support Assets	42,177,009	5,812,182	0.138	5,129,171	0.122
<u>Central Office Switching</u>						
2211	Analog Electronic Switching	6,923,001	377,964	0.055		
2212	Digital Electronic Switching	53,064,835	2,843,667	0.054		
2215	Electro-Mechanical Switching	<u>87,057</u>	<u>10,605</u>	<u>0.122</u>		
2210	Total Central Office Switching	60,074,893	3,232,235	0.054	3,232,235	0.054
2220	Operator Systems	954,529	107,087	0.112	107,087	0.112
<u>Central Office Transmission</u>						
2231	Radio Systems	1,364,019	22,867	0.017		
2232	Circuit Equipment	<u>57,760,638</u>	<u>1,126,439</u>	<u>0.020</u>		
2230	Total Central Office Transmission	59,124,657	1,149,307	0.019	1,149,307	0.019
<u>Information Orig/Term</u>						
2311	Station Apparatus	329,901	647,588	1.963		
2321	Customer Premises Wiring	143,466	--	--		
2341	Large Private Branch Exchanges	172,832	292,851	1.694		
2351	Public Telephone Terminal Equipment	1,339,544	320,536	0.239		
2362	Other Terminal Equipment	<u>2,956,396</u>	<u>2,222,291</u>	<u>0.752</u>		
2310	Total Information Orig/Term	4,942,141	3,483,265	0.705	3,483,265	0.705
<u>Cable & Wire Facilities</u>						
2411	Poles	6,055,758	310,833	0.051		
2421	Aerial Cable	31,701,992	2,899,649	0.091		
2422	Underground Cable	26,137,201	752,837	0.029		
2423	Buried Cable	50,995,111	2,854,195	0.056		
2424	Submarine Cable	99,624	1,757	0.018		
2425	Deep Sea Cable	17,793	37	0.002		
2426	Intrabuilding Network Cable	2,308,327	69,154	0.030		
2431	Aerial Wire	189,933	9,644	0.051		
2441	Conduit Systems	<u>17,031,443</u>	<u>203,665</u>	<u>0.012</u>		
2410	Total Cable & Wire Facilities	134,537,185	7,101,787	0.053	7,101,787	0.053
240	Total Plant	301,810,418	20,885,863	0.069	20,202,849	0.067

Note: Class A expense before clearance in A/Cs 2112, 2113, 2114, and 2116.

Source: Table 2.9, 1997 Preliminary Statistics of Common Carriers

Depreciation Reserve Percent

All Lecs



All LEC's Plant Related Rates
(Dollars in Millions)

	Telecommunications Plant in Service				Add (e)	Ret (f)	Deprec (g)	EOY Reserve (h)	AVG Reserve (i)	Add Rate (j) = e/a	Retire Rate (k) = f/a	Deprec Rate (l) = g/c	Reserve Percent (m) = h/b
	BOY (a)	EOY (b)	Average (c)=(a+b)/2	Increase (d) = b-a									
1946		6,500	3,250	6,500				2,300					35.4
1947	6,500	7,400	6,950	900				2,500	2,400				33.8
1948	7,400	8,700	8,050	1,300				2,600	2,550				29.9
1949	8,700	9,800	9,250	1,100				2,800	2,700				28.6
1950	9,800	10,500	10,150	700				3,000	2,900				28.6
1951	10,500	11,300	10,900	800				3,200	3,100				28.3
1952	11,300	12,300	11,800	1,000				3,400	3,300				27.6
1953	12,300	13,400	12,850	1,100				3,600	3,500				26.9
1954	13,400	14,600	14,000	1,200				3,800	3,700				26.0
1955	14,600	15,800	15,200	1,200				4,100	3,950				25.9
1956	15,800	17,400	16,600	1,600				4,300	4,200				24.7
1957	17,400	19,600	18,500	2,200				4,600	4,450				23.5
1958	19,600	22,000	20,800	2,400				4,900	4,750				22.3
1959	22,000	23,000	22,500	1,000				5,200	5,050				22.6
1960	23,000	25,000	24,000	2,000	2,700	700	1,100	5,600	5,400	11.7	3.0	4.6	22.4
1961	25,000	27,000	26,000	2,000	2,800	800	1,200	6,000	5,800	11.2	3.2	4.6	22.2
1962	27,000	29,000	28,000	2,000	2,900	900	1,300	6,400	6,200	10.7	3.3	4.6	22.1
1963	29,000	32,000	30,500	3,000	4,000	1,000	1,400	6,800	6,600	13.8	3.4	4.6	21.3
1964	32,000	34,000	33,000	2,000	2,900	900	1,600	7,500	7,150	9.1	2.8	4.8	22.1
1965	34,000	37,000	35,500	3,000	4,100	1,100	1,700	8,100	7,800	12.1	3.2	4.8	21.9
1966	37,000	40,000	38,500	3,000	4,100	1,100	1,900	8,900	8,500	11.1	3.0	4.9	22.3
1967	40,000	44,000	42,000	4,000	5,100	1,100	2,100	9,900	9,400	12.8	2.8	5.0	22.5